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ABSTRACT

In this booklet, one of a series intended to apply economic principles to major social and political issues of the day, the position is taken that questions of fairness have little meaning when discussing economic issues like prices, wages, and profits. It is argued that one reason for the frequent use of terms like fair and fairness is ignorance about the market and how the market determines prices, wages, and profits. Thus, the notion that market-determined value has little to do with the actual characteristics of products, services, or jobs but is instead a function of supply and demand in the relevant markets is very difficult for many to understand or accept. Fair and unfair are also terms that arouse people's emotions and are often used to rally support for or to attack other positions. Thus, it is suggested that economic understanding can be advanced by recognizing that virtually any market outcome will be perceived as favorable by some individuals and unfavorable by others. It is concluded that attempting to tamper with the market will only harm the economy, rather than create situations that some will see as fair. (IS)

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Introduction

Discussions of economic issues often are sprinkled with phrases like "fair prices" or "fair profits" or "fair wages." By using these terms in conversations, news accounts, editorials and articles, we imply that some prices, profits or wages are fair while others are unfair. What distinguishes a fair price from an unfair price? Why are wages or salaries in some professions perceived to be more fair than in other occupations? If high profits are unfair, what about low profits—are they also unfair?

This monograph will attempt to convince the reader that these questions generate more smoke than fire. Terms like fair and unfair arouse emotions but have little meaning in an economic context.

We began with questions that beg for a definition of terms, but thinking of examples often is easier than defining terms, especially when we are trying to separate that which is fair from that which is unfair. Consider these three anecdotes.

•1. Several years ago a major hurricane knocked out electrical power in most of southern Alabama. Some residents of neighboring states spared by the storm drove to the areas without power and began selling bags of ice from coolers in their pickup trucks. Many of these "entrepreneurs" were able to sell 10-pound bags of ice for $5 per bag to residents without electricity. Many of these bags of ice were purchased hours before at 99 cents per bag in fast food stores located outside the area hit by the storm. Television reporters on the scene described this activity as "profiteering" or "price gouging" and their cameras zoomed in on the bags of ice with their 99-cent price tags still visible as they changed hands for $5 per bag. Was this an example of an unfair price? Many would say yes.

•2. Not many years before the hurricane in Alabama, one of America's best female tennis players created quite a storm by criticizing the practice of awarding women tennis champions smaller cash prizes than men earned in the same tournament. Billie Jean King argued that women players practice just as hard as men players, play on the same sized court with the same ball and racquet as the men, and yet the top prizes for women are smaller than the top prizes for men. This is unfair according to Ms. King, and many others agree.

•3. Teachers' salaries are the subject of considerable controversy in many communities across the United States. One very sensitive issue is the comparison of teachers' salaries with those earned in other occupations, particularly in the so-called unskilled jobs. In several communities the fact that garbage collectors earn more than teachers is regarded not only as evidence that teachers salaries are unfair, but also prompts some to suggest that this is evidence of a society where values have been perverted.

Each of these examples may lead us to conclude that the prices or wages discussed are unfair. However, in each case the described outcome can result from the ordinary working of a free market. Part of the controversy in each anecdote described above stems from a misunderstanding of what determines market prices or wages.

An alternative source of controversy in these anecdotes stems from the fact that market-determined value may be quite different from the value placed on a commodity or a job by an individual. These differences in value are common among buyers and sellers and employees and employers.

Determining Value in the Market

Think about the residential real estate market. The market value of two physically identical 1-year-old houses located 20 miles apart may be quite different. Furthermore, two months from now, the market value of each house may be quite different than it is today. We probably can think of many reasons why both of these statements could be true.

One house may be in a neighborhood near the site of a recently announced medical center that will bring hundreds of new jobs to the community. With these new jobs will come an increased demand for housing near the new center. The other house may be in a community where a domestic automobile manufacturer, one of the primary employers, is reducing its workforce and many people are leaving to seek work elsewhere.

Two months later, an announcement is made in the first town that expected government grants to fund a major part of the medical center will not be forthcoming and the center's construction has been postponed indefinitely. Real estate prices around the proposed site decline sharply. In the other town, Toyota has purchased the automobile plant and announced that it will expand and modernize the facility and employ twice as many workers there as the previous employer did. Real estate prices in this town soar.

Thus, the physical characteristics of a house tell us little about it's market value unless we know where the house is and when it is for sale.

This simple example illustrates a very important feature of market determined value: ***It is subjective.*** In the market, the value of ***anything*** depends on where it is located in time and space. The logic behind this conclusion is easy for us to follow but it often is difficult for us to realize how pervasive this principle is.

Consider this. If I own an antique car in which I have invested $15,000 and countless hours of sweat and toil, I may say I have a $15,000 car. But what does this mean? I can't sell the car for $15,000 unless I can

find a buyer willing and able to pay that amount. The best I may be able to do today is an offer of $11,000. I won't sell because today the car is worth at least $15,000 to me. Next week a tree falls on my house and I find out that I don't have the right insurance coverage and need a lot of cash to pay for the repairs. I put my antique car on the market but the best offer I can get is $9,000. I sell. Was it a $15,000 car or was it a $9,000 car? Last week its market value was at least $11,000. Maybe if I advertised it in another town I could have gotten even more the next week.

This principle of subjective value also can be confirmed with simple deductive reasoning. If value was not subjective—if it was objective—why would people ever exchange anything? It is the difference in subjective value that enables two people to trade objects and both be better off after the trade. The objects traded, say a basket of peaches for a basket of tomatoes, are not physically different after the trade. The individual who gets the tomatoes values them more than he values the basket of peaches he gives up. The other trader has the opposite subjective ranking of peaches over tomatoes. Does it make any sense to ask whether peaches are more valuable than tomatoes in this setting?

Now suppose that two other pairs of traders are exchanging tomatoes and peaches at separate locations from the first traders described above. At one location, two baskets of peaches are exchanged for one basket of tomatoes, while at the other location two baskets of tomatoes are exchanged for one basket of peaches. Is it meaningful to ask which of the three exchange ratios (prices) is "fair?" Of course, the prices may be quite different tomorrow or the next day or with different traders. A trader with an allergy to peaches may not be willing to trade a single tomato for a basket of peaches but might be very interested in trading for prunes.

The markets for ice, tennis players, teachers and garbage collectors work the same way as the market for peaches and tomatoes. Consider each of the introductory examples again.

Ice. The ice that sold on a normal day in Atlanta for 99 cents per 10-pound bag was worth $5 to some Alabama residents with freezers full of food after the hurricane knocked out their electricity. Unfortunately for Alabama residents, the 99-cent ice was in Georgia and they needed it in Alabama. Fortunately some Georgia residents were willing to take the ice down to Alabama for the expected price of $5 per bag. Was $5 per bag a fair price for the ice? It certainly was the market price in some locations for some period of time. So we can say that the ice was worth at least $5 to some Alabama residents and that $5 was more than the ice was worth to the Georgia residents who sold it from the back of their pickup trucks.

Actually $5 exceeded not only the value of the ice to the Georgia residents, but also their time, gasoline and other expenses and the risk associated with their entreprenurial venture. The risk in one-time activities like this is often quite high. Suppose the power is restored to the

communities you are intending to sell ice to as you drive into town, or suppose your truck has mechanical trouble on the trip and the ice melts while you are waiting for repairs. What we saw on the television news reports were the activities of the *successful* ice merchants who made the trip and found customers for their ice. (What was the value of bags of ice in a truck waiting for repairs on the side of the road?)

Tennis Matches. Like ice, there is no objective value for a tennis match. The value of a tennis match depends on who's playing, who's watching, where the match is, when the match is, etc. The fact that most matches have physically similar features—size of the court, number of players, size of the ball, approximate size of the racquet, number of sets—has little to do with determining the market value of any particular match.

The market value of the match largely determines the amount of prize money available. Men's singles matches are the most popular matches in terms of attracting crowds and television audiences. As a result, prize money available to attract male tennis players to major tournaments is greater than the prize money for female tennis players.

Ms. King's argument that female prizes should be the same as male prizes ignored the real difference in market-determined value of the matches. Was the market for professional tennis matches unfair to women? If so, is it also unfair to male tennis players of only average skill or ability? What about "seniors," whose tournaments draw relatively small crowds, are seldom on television and have small prizes? What about the market for professional endorsements where the top male stars again often earn more than women professionals or senior professionals? Are all of these markets unfair?

Teachers and Garbage Collectors. Some readers may think this example is distinctly different from the ice and the tennis tournaments. After all, teachers' salaries are usually established by a school board or some governmental body and not in a free market. This is true, but it does not necessarily mean that the market forces of supply and demand do not influence salaries. Although there are exceptions, the great majority of school boards do not have shortages of applicants for most of their elementary and secondary positions.

In a free market setting, salaries tend to move in a manner that equates supply and demand. Shortages in a particular profession tend to drive salaries up while a surplus of qualified applicants will result in lower salaries. In other words, the few observed shortages of teachers, with the notable exception of math, science and a few other specialties in selected areas, indicate that teacher's salaries are not below what we would expect from the free market.

It is important to recognize that the absence of widespread shortages of teachers at current salary levels is a function of ***declining demand*** for teachers as the number of school age children declines, as well as the

additions to the supply of teachers from the nation's many colleges of education.

Some garbage collectors are members of labor unions and earn salaries established through collective bargaining procedures, as do teachers in some parts of the country. In these cases the salaries tend to be higher than they would be in a free market setting. However, in some areas where the comparisons between teachers' and garbage collectors' salaries have been made, the garbage collectors are not unionized and salaries are determined directly by the market. In these cases, shortages of people willing to collect garbage in the face of growing demand for garbage collection have driven salaries above the levels paid to teachers.

The fact that garbage collectors do not need college educations, or that their task is judged by many of us to be less "important" than molding the minds of the next generation of Americans, has little to do with the market forces that determine the relative differences in the salaries of the two professions. In fact, the stigma associated with the occupation of garbage collection tends to reduce the supply of young people willing to make a career in "garbage," and that forces wages up even more. Because education is a profession that tends to be highly regarded in most communities (even if the pay is not high), the supply of young people willing to enter the profession is relatively higher than it is for less respectable occupations. In this case the relatively high and low regard that society has for two professions contributes to the apparently perverse salary differences.

The bottom line of our discussion so far is that the physical characteristics of a good (the size of a bag of ice or the attributes of championship tennis), or the nature of a service (education versus garbage collection), are not the primary determinants of value. Therefore any discussion of fairness that focuses of these characteristics omits important market attributes that ultimately determine the value of these goods and services in the marketplace. In fact, market differences are usually much more important in determining value than are physical similarities. However, physical differences or similarities are much easier for most of us to observe, which leads to some of our confusion about fair prices and wages.

Market-determined value may be easier for us to understand after the discussion of these examples, but we may be less enamored with market outcomes. The popularity of the market as an institution may decline as we learn more about it. After all, it is hard for some of us to be enthusiastic about an institution that sanctions paying garbage collectors more than teachers (unless garbage is our line of business). But before we become socialists, let's examine some familiar situations where we do not use the market to determine value of important goods and services in our country. The comparison of market and nonmarket outcomes may restore some of our faith.

Determining Value in Nonmarket Settings

Concerns of "fairness" are often cited as justification for not using the market to allocate some goods and services. In other cases fairness is often the justification given for suspending market operations under unusual circumstances. But are nonmarket outcomes fairer than market outcomes? Let's consider some common examples.

Bottled water is like milk in some respects—both are good to drink, both are sold in similar-sized containers in supermarkets and prices of each are determined by market forces. But a gallon of drinking water is much cheaper in most stores than a gallon of milk. However, most of the water we "consume" is not bottled nor is it priced by the market. If we live in a town or a city with a community water supply, prices are set by some administrative agency and seldom change with the pressures of supply and demand.

When a water shortage occurs in the summertime, we encounter the standard problem of demand exceeding supply at the current price. Any type of shortage can be eliminated by allowing the price to rise to a new equilibrium level that will equate supply and demand. However, few cities or towns experiencing water shortages seriously consider raising the price of water to bring demand and supply into balance. Why not?

Many people might answer by saying water is a necessity and it would be unfair to raise the price of water. This is a popular but peculiar answer. It implies that all the water we consume during a shortage is a "necessity" and it also implies that the nonmarket means used to allocate water during shortages are more fair than the market would be. Let's consider the common ways to ration water in closer detail and see if these implications are justified.

Cities and towns experiencing water shortages often respond first by asking people to voluntarily reduce their consumption. If people do this it tells us that not all of their water consumption is necessary; they can voluntarily do without some of the water they might otherwise consume. If the water shortage persists something else must be done. The next step usually is to formally ration water by restricting its use. Executive orders or ordinances are issued to prevent people from using water in certain ways. Common restrictions include prohibitions on watering shrubs and lawns, washing cars, trucks or boats and filling swimming pools. If people comply with these restrictions, that is more evidence that not all water consumption is necessary, but is instead discretionary.

The standard rationale for choosing water rationing over raising the price of water is that rationing is fairer. Rationing restricts everyone in the same way whereas raising the price may make it harder for low income consumers to purchase as much water as high income consum-

ers. It is a common notion that rationing restrictions are fair because they result in equal sharing of the burden. Everyone, rich or poor, has to stop watering their lawn or washing their car or filling their swimming pool.

The problem with this popular line of reasoning is that because people have different tastes and preferences, restrictions that prohibit using water or anything else in a particular way affect people quite differently. You and I may be similar in many ways; we may both be teachers earning the same income, both live in similar houses in the same neighborhood with the same sized families. But we may have different nobbies.

You are a gardener and raise vegetables and flowers in your yard and my hobby is tennis. You spend long hours working in your garden in the evenings and weekends while I am working on my backhand and my topspin lob. A water rationing ordinance that prohibits watering lawns and gardens will impose substantial hardships on you. You will not be able to continue your favorite hobby and your plants, vegetables and flowers may die. If I can't water my grass it won't grow as fast and I will have more time to play tennis. Is this a fair way to share the burden of a water shortage?

Consider another example of two families living in the same town with very different incomes. You are quite wealthy and I am not. You own a summer home on a lake in the Texas Hill Country and take your family there to swim and water ski every weekend in the summer. I can't afford anything like that but I did manage to buy a small above ground pool from Sears (on credit) for $500. My family tries to beat the heat in the summer in our backyard pool.

The same water rationing ordinance will affect us very differently. In this case the lower income family will bare substantial costs (the loss of the use of their small swimming pool) while the wealthy family will bear little if any cost since they do not have a pool and don't spend much time during the summer in their yard. We could construct dozens of similar examples like these. The point is that attempts to ration anything by restricting its use will affect people quite differently. Some people will bear substantial burdens—or costs, in the economist's jargon—while others will bear little cost.

Let's compare the way the market allocates the cost when there is a shortage of a commodity like water. Most water shortages usually occur when high temperatures increase the demand for water and reduce the supply in reservoirs or lower the water table. The rationing efforts discussed above are attempts to reduce the demand for water during the shortage. Raising the price of water also will reduce the demand. As individuals face higher prices for water they will have to decide whether to consume the same number of gallons of water and pay a higher water bill during the summer or whether they will cut back their consumption

of water. If they continue to consume the same number of gallons they will have to cut back on the consumption of something else or draw on their savings to make their monthly budget balance. In either case these decisions will be made by the individual consumer.

There is a common tendency for some to question whether people can make adjustments when faced with higher prices for goods like water. The average individual consumption of water in the United States is over 150 gallons of water per day. Certainly there is room for substantial reductions in consumption without having people go thirsty —or dirty for that matter. (You can sing a lot of songs in the shower with 30 gallons of water.) If daily consumption is 150 gallons per day, a 30 percent reduction in water consumption by an individual would still leave more than 100 gallons of water for daily consumption. In many water shortages, a 30 percent reduction in consumption is more than enough to match demand with available supply.

How would people reduce the consumption of water by 30 percent? When confronted with higher prices for water, individual consumers would decide what trade offs they wanted to make. Many probably would cut back on the use of water for the activities discussed in the rationing plan above. Some would not water their lawns or shrubs as much, some might stop watering all together. Some would not wash their cars as frequently but might continue to water gardens. People with swimming pools and children who are going to camp for part of the summer may not refill their pools, while others may keep the pools full and cut back on watering the lawn. Some people may decide not to reduce their consumption at all, but to pay higher monthly water bills during the shortage. As in the rationing example above, the total consumption of water will be reduced as higher prices encourage people to economize on water usage.

The primary difference between the rationing approach and the market approach is *who* decides what water consumers will give up. In the rationing approach someone in city hall will decide what you and I should give up. In the market you and I will decide what we will give up as the price of water rises. We will give up those uses which are least valuable to us. Determining the least valuable uses of water is something that we can do on an individual basis much easier than someone else can do it for us, because we have the most information on the subjective value of water to us. Rationing appears at first glance to be more fair because many of us mistakenly presume that water uses have some objective value and that we can fairly distribute the burden of a water shortage by stopping everyone from using water in "low valued" ways. Actually the market solution will result in the lowest cost water conservation as each individual consumer minimizes his or her cost of reducing water consumption.

Gasoline is Just Like Water

Gasoline rationing during the 1973 Arab oil embargo is another example of how some policy makers argue that the market would be an unfair method for allocating gasoline during the shortage. The embargo by Arab oil producing nations reduced the supply of crude oil coming into the United States. This was quickly translated into a shortage of gasoline at current market prices. However, price controls imposed by President Nixon several years earlier were still in effect and the shortage of gasoline did not result in rising prices as would have happened in a free market.

Economists at the time estimated that the controlled price of approximately 45 to 50 cents per gallon would rise to 75 to 80 cents per gallon in the short run under free market conditions. A number of politicians and others argued that the poor would not be able to adjust to such high prices for a "necessity" like gasoline, and as a result the price controls were not removed. Instead, many states supplemented the price controls with additional rationing devices, such as limiting to 10 gallons the amount of gasoline any purchaser could buy, closing gas stations on Sundays and instituting "odd-even" plans where a driver could only buy gasoline on odd dates if the last number in his or her license plate was odd.

Owners of service stations also made some adjustments of their own to the unusual market conditions resulting from the embargo, price controls and rationing schemes. Since they had fewer gallons of gasoline to sell as a result of the embargo but they could not raise prices because of the price controls, many service station owners reduced the number of hours they were open in order to cut operating costs. Selling fewer gallons of gasoline could be accomplished in fewer hours. At the artifically low prices there were plenty of customers, particularly where you could only buy 10 gallons at a time. Many service stations began opening later and closing earlier, and as a result some people had to take off from work to get to a station while it was open. Others only sold gasoline to customers who also bought a carwash as a way to get around the price controls. This added several additional dollars to the price of buying the gasoline.

Regardless of these adjustments, most consumers waited in lines to buy gasoline during this period, in effect an additional cost of buying gasoline. If you were traveling, there was also the uncertainty of finding an open station when you needed one, so many people kept their tanks at least half full. With customers carrying their own "inventories" around with them, uncertainty became another cost. This practice further increased the demand for gasoline during the shortage.

Some consumers bought extra portable gas cans which they kept filled in the trunks of their cars as a way to protect themselves against

the possibility of not finding an open station when they wanted one. Law enforcement officers and other safety officials warned that carrying cans of gasoline in the trunk was like driving around a fire bomb. However, a number of drivers were willing to bear this substantial risk in order to drive farther than they otherwise could.

If the free market had been used to allocate gasoline during the embargo, the price of gasoline would have risen to about 80 cents per gallon in the shortrun. (We'll talk about the long run a little later.) As with the water shortage example above, consumers would make individual decisions about how to economize on their use of gasoline. Many of those opposing free markets for gasoline contended there were no substitutes for gasoline. Certainly there are few physical substitutes for gasoline in an automobile engine, but there are ways to reduce the use of gasoline in an automobile. Carpooling, better organizing trips to the store, using public transportation where available and reducing leisure travel all are shortrun substitutes for using gasoline. Many of these substitutes are available to consumers at all income levels as well. The point is that consumers will make adjustments in their consumption of gasoline in response to the rising price.

Because the Arab oil embargo is an actual historical event, we can compare the nonmarket schemes used with the market alternative and attempt to evaluate the impact of each method of dealing with the shortage of gasoline. Let's consider the plight of the poor since that group was frequently cited as the one that would be most adversely affected by a free market.

Under the schemes adopted in most states, poor people and anyone else could buy 10 gallons of gasoline for about 50 cents per gallon or $5—when the station was open and after waiting in line. Two hours was not an uncommon wait and waits of up to three hours occurred in some areas. The total cost of buying 10 gallons of gasoline was $5 plus the cost of waiting in line plus any uncertainty associated with knowing whether a particular station might be open.

Perhaps the lowest cost of a poor person's time would be the wages given up while waiting in line. The minimum wage during the embargo was $2.25 per hour, so the cost of waiting in line for two hours during a working day would be $4.50. If we ignore the uncertainty associated with the station being opened, the cost of 10 gallons was $5 for the gas plus $4.50 for waiting in line, or $9.50 total cost. If the free market estimated price of 80 cents per gallon was correct, the cost of 10 gallons in an uncontrolled market would have been $8 with no waiting in line. Furthermore, if 80 cents per gallon was the equilibrium price after the embargo, service stations would be open the same number of hours as before the embargo in an effort to attract customers to their station.

Thus it appears that efforts to use nonmarket rationing schemes to help the poor resulted in having them pay $9.50 for gasoline that they

could have bought for $8 under free market conditions. Actually these rationing procedures may have been even more costly to some poor people. As noted above, most service stations were open only during normal working hours. Many poor people who work have hourly wage jobs where they are paid only for the hours they work. If they are not there, they don't get paid. In many of these jobs it's not easy to take time off during the work day to do other things such as sit in gas lines. When the worker is not there other workers cannot do their job; the carpenter's work is affected when the carpenter's helper is not on the job, the assembly line doesn't function efficiently when one of the workers is not at his or her position. On the other hand, highly paid, salaried workers like college professors may find it relatively easy to rearrange their schedules and sit in gas lines during the middle of a work day while grading papers.

Once again we see that the individual worker is in the best position to determine what will be the lowest cost ways to adjust to rising gasoline prices. Lower prices at the pumps but longer waits in line and the uncertainty of purchase will impose different costs on different people and will not necessarily make poor people better off than they would be under a free market scheme.

What about the question of fairness? Are nonmarket means of rationing goods fairer than the free market would be? Our discussion so far has implied that the concept of fairness is much more difficult to apply to economic matter than we may have realized.

Equal Pay, Comparable Worth and the Market

One economic issue where the notion of fairness seems to have straightforward application is the payment of equal wages for equal work. That is, many of us believe that paying people different wages for performing what appear to be identical tasks is unfair. The courts and many public and private organizations appear to uphold the concept of equal pay for equal work. Even so, we will find once again that market outcomes can differ from our preconceived notions of fairness.

The profession of education can provide us with numerous examples. There are relatively few senior high school mathematics and science teachers compared to social studies teachers. Teachers in each area may view their teaching job as identical on all dimensions except for the nature of the subjects taught. However, because of differences in supply of qualified applicants, many school districts find they either have to offer some sort of bonus to science and math teachers or they have to staff these positions with applicants lacking qualifications. That is, the market will generate different salaries for these teachers despite

the similarities in the nature of their work. In this case one of the key market factors is the range of alternative employment opportunities for math and science majors.

A similar situation could occur in elementary education. There are far fewer male elementary teachers than female teachers. As a result, schools desiring to hire teachers of both sexes to provide role models for students will have to pay more to attract the relatively fewer men in the profession, or have few men teaching in the elementary grades. Since salary differentials are unlikely, the latter outcome is common in most school systems. In this example, the nature of the job is identical on all dimensions. However, the supply factor generates different wages in a free market. If wages are not different, shortages will exist as is frequently the case.

The same type of situation can result when trying to hire teachers of different racial or ethnic backgrounds. In some geographic areas and in some academic disciplines there are relatively few minorities. Schools that want minorities represented in their faculty will have to offer higher wages to attract certain minority candidates or have shortages of minority teachers on their faculties.

The concept of equal pay for "comparable" work has been the focal point for a growing debate and an increasing number of court cases. Comparable work is distinguished from equal work by phrases like "equal skill, effort and responsibility, and performed under similar working conditions." Advocates of the comparable worth concept believe that workers in comparable jobs should receive the same pay.

Many of these advocates recognize that they are concentrating on only the internal job characteristics and ignoring external supply and demand factors that affect market-determined values. However, they claim that these external market forces result from discrimination and other inequities in society, and thus equal pay for comparable worth is fairer than market-determined wages. The degree to which sexism, racism and other "inequities" have adversely affected the opportunities of some employees is a complex empirical question and it's validity is outside the scope of our discussion. However, for illustrative purposes, assume these accusations are found to have widespread verification. What impact would equal pay for comparable work have on those who have been discriminated against?

Suppose women and minorities have been forced into certain professions that have lower wages than other professions that appear to be "comparable," and wages in these lower paying jobs are raised by law, not by market forces. One predictable result is that at higher wages fewer workers will be demanded in the comparable jobs. Furthermore, substitutes for the more expensive employees, such as more capital intensive production techniques, will be sought. The substitutions of capital for labor—such as more automated office equipment and fewer

secretaries—will take place over time, although the cause and effect relationship may be missed by outside observers. Nonetheless, the effect on employees will be mixed. Those who retain their jobs may earn higher wages as a result of comparable worth laws, at least in the short run. Those who are replaced by capital intensive production techniques or not hired in the first place because of the mandated higher wages may be worse off than they were with a lower-paying job.

An additional consequence of the comparable worth doctrine may be even more subtle. What happens to our overall economic system as we move away from market-determined value for goods and services? The argument that supply and demand factors should be ignored for one reason or another may seem appealing in individual cases. That is a value judgement anyone can make. We can only say that the market does not ignore these factors. Non-market determinations of value must be made by some governmental body as was the case in the water and gasoline rationing examples discussed above.

If we move away from the market as a means to determine value in some professions, where do we draw the line? Why not all professions? Why not all exchanges of goods and services? Some readers may think this is an overreaction, but look at possible implications of nonmarket-determined value in the so-called "unisex" issue in the insurance industry as an example.

Actuarial tables indicate that women as a group have longer average life spans than men do as a group. Women also have fewer automobile accidents on average than men do. The differences in average life span have meant lower life insurance rates for women than for men of the same age. In some pension plans and annuities, plans worth the same total dollar value would pay women less in yearly benefits than men of the same age because women would be collecting benefits for more years than men. Like life insurance, automobile insurance rates for women tend to be less than for men of the same age. In recent years these practices have been challenged in the courts as examples of sexual descrimination. The courts have generally agreed and now many insurance companies do not have different rates for men and women nor do they have different payout schedules for annuities or pension plans.

While the court rulings have changed the rate structures and the payout schedules that insurance companies can use, they have not changed the differences in life spans or accident rates upon which the old fees and benfits were based. As a result, the unisex life insurance rate is an average of the previous rates charged for men and women. Men pay rates that are lower than they used to be and women pay rates that are higher. Thus women who have longer life spans are subsidizing men who do not. The same is true with automobile insurance rates. For annuities and pension plans, men will subsidize women.

Unisex rates and payouts have not caused major disruptions in the insurance industry, but they have established a precedent that requires insurance companies to ignore actual differences that do result in different rates for different sexes. How long will it be before different rates for different *ages* are challenged on the grounds that this is age discrimination? The age discrimination case could be a carbon copy of the sex discrimination case. Imagine the implication of this issue for the insurance industry.

Ignoring the market factors that determine value requires that we use nonmarket decision rules to allocate goods, services and resources. An economy where most economic decisions are made by nonmarket means is called a ***command economy.*** Command economies exist in most socialist countries of the world and can be compared to market economies on many dimensions.

Are Profits Fair?

In addition to prices and wages, profits are frequently alleged to be "unfair" by some market critics. Once again we shall see that common use of the term "unfair profit" has done little to develop an operational definition of the concept. Let's begin by looking at the definition of profit without any modifying adjectives.

Profit is the residual an individual or a corporation has left after paying the contractual obligations of the business, such as wages, rent, interest on debt, cost of supplies, etc. Unlike wages, rent, or interest, profit can be either positive or negative. It is the opportunity or the chance to earn positive profit that motivates most businesspeople to enter a market. Likewise, the absence of opportunity or the diminished chance to earn profits discourages entry in a market. Changes in supply and demand in any market will affect the opportunities to earn a profit in that market. Thus profit plays a key role in coordinating the resource allocations among markets in our economy.

Some of those who object to profits they perceive to be excessive or unfair fail to understand the functional role of profits. Profits that are high relative to what they were expected to be, or high relative to what they were last year, or high relative to what they are in other industries operating under similar circumstances will usually have a predictable economic result.

Investment in the market where the high profits are being earned will increase substantially as existing firms and new entrants in the market will compete for the opportunity to earn the high profits. This competition will increase the supply of the product compared to what it would have been in the absence of the profit-induced investment expansion. Increases in supply with no corresponding increases in demand will mean that profits will soon return to more "normal" levels.

Let's go back for a moment to the example of selling ice in Alabama. The initially high retail price of $5 per bag relative to the purchase price of 99 cents per bag in nearby states may have lead to initially high profits for the ice entrepreneurs. If the electrical power outage had continued for a few more days, more organized efforts to bring ice in large refrigerated trucks to Alabama would surely have developed, and this substantial increase in supply would have resulted in sharply falling prices for bags of ice. In a few days, the price for ice in Alabama probably would exceed the price in neighboring states by only the cost of the most efficient transportation to the stricken areas. Were profits in the first day or so of the crisis too high or unfair? Who is to say? We can say that if by some executive order Alabama officials prevented the ice entrepreneurs from charging prices that resulted in high profits, fewer people would have traveled to Alabama with ice for sale.

Consider another example that is closer to home. In 1979 and 1980, a number of critics of the oil industry in this country complained that the profits of large oil companies were excessive, obscene or otherwise too high. These complaints prompted several of my colleagues and me to examine profits earned by large oil companies.

Much of the attention of those oil industry critics focused on the absolute dollar size of the reported earnings of the largest energy companies. Since the major oil companies are among the largest American corporations, any measure of their financial activities will involve large dollar figures. Whether profits of large oil companies are high or low requires *relative* measures of their earnings, measures that compare earnings to previous years or to other major industries.

In a sentence, our work found that except for 1980, earnings of most major oil companies were not high by most meaningful measures. Our next question was whether, during the period when earnings were relatively high, there was a corresponding increase in investment in the industry. That is, were the high profits having the appropriate effect on attracting resource allocation toward the industry? Drilling rig counts were at an all time high during 1980, and most of the drilling was in the most expensive off shore areas. Entry into the industry was also very high as hundreds of new companies were formed to search for oil and to invest in alternative products that may be substitutes for the consumption of oil and its derivatives.

During a radio talk show following the publication of our findings, we were asked by the host if we thought that $1 billion in profit for one of the major oil companies was too high. Our response was "too high for what?" Did it induce too much new drilling or too much new entry into the industry? Needless to say our host was stymied by our response, but the point we were trying to make was that profits serve a purpose in our economic system and in this case the evidence indicated that the expected response to high profit levels was occurring. We wanted to

know if the radio host thought the response was too great. He agreed that there was a shortage of oil relative to demand at current prices but he did not understand the impact of higher profits on future exploration and production.

Conclusion

Questions of "fairness" have little meaning when discussing economic issues like prices, wages or profits: "Fair" is a most ambiguous word when applied to economic issues. So why is it used so frequently in speech and print? Two possible reasons seem most likely, and the reader can decide which is most appropriate in a given situation.

One reason for the frequent use of terms like fair and fairness is ignorance about the market and how the market determines prices, wages and profits. In particular, the notion that market-determined value has little to do with physical characteristics of products, services or jobs but is instead a function of supply and demand in the relevant markets is very difficult for many to understand or accept.

A second reason common to political discussions is that fair, and its opposite unfair, are words that arouse emotions. Proponents and opponents of changes in prices, wages or profits find these terms useful to rally support or attack each other's position.

Economic understanding can be advanced by recognizing that virtually any market outcome will be perceived as favorable by some individuals and unfavorable by others. Frequently the concept of fairness is invoked to rationalize criticism of market outcomes. If we attempt to use nonmarket means to make the market more fair, we may indeed be opening the proverbial Pandora's box.

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The research monograph series is designed to provide intrepretations of technical articles appearing in scholarly journals. The monographs often are useful for teachers who are addressing current economic issues in the classroom.

1. *The Economics of Industrial Democracy: An Analysis of Labor Participation in the Management of Business Firms* by Eirik G. Furubotn.
2. *International Price Stabilization and the Less Developed Countries: Lessons from History* by John R. Hanson, II.
3. *Distortions in Official Unemployment Statistics: Implications for Public Policy Making* by Kenneth W. Clarkson and Roger E. Meiners.
4. *Profitability of Major Oil Companies: Normal Returns or Windfall Profits?* by Gerald D. Keim, Barry D. Baysinger, Roger E. Meiners and Gary D. Libecap.
5. *The Inflationary Impact of Labor Unions* by Dwight R. Lee.
6. *The Foundations of Free Enterprise* by John W. Allen, David G. Armstrong and Lawrence C. Wolken.
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Other Publications

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The Political Economy of Federal Government Growth: 1959-1978 by James T. Bennett and Manual H. Johnson. (Paper-$4.95, cloth-$12.95)

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Dr. Gerald D. Keim is an associate professor of management in the College of Business Administration at Texas A&M University. He is the leader of the Business, Public Policy and Law Group in the department of management and has won college-wide awards for outstanding teaching and research. His research has focused on the interface between corporations and their external environments, with particular emphasis on corporate political activity. His work has been published in leading management and public policy journals. Dr. Kein also has worked as a consultant for several of the nation's largest energy corporations, including Conoco and Sohio. He has a B.S. in economics from the University of Delaware and an M.A. and Ph.D. in economics from the Virginia Polytechnic Institute.

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